



OFFICES OF THE COUNTY EXECUTIVE

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County Executive

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May 14, 2010

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2010. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan. There were approximately 5,950 active members and 5,420 retirees participating in the ERS as of March 31, 2010.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 3.11%, 3 basis points ahead of the 3.08% gain recorded by the policy benchmark. For the one year period ending March 31, 2010 the ERS' gross return (before fees) was a gain of 32.09%, 4 basis points ahead of the 32.05% gain recorded by the policy benchmark. The one-year return, after fees, places the ERS' performance in the top 48% of a universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was a gain of 0.48%, after fees, ranking in the top 16% of the universe. The asset allocation at March 31, 2010 was: Domestic Equities 27.9%, International Equities 20.3%, Fixed Income 25.7%, Inflation Linked Bonds 9.3%, Commodities 5.0%, Private Equity 6.2%, Real Estate 2.6%, Opportunistic 2.2%, and Cash 0.8%. We estimate that the funded status of the ERS was 78.9% as of March 31, 2010, a slight decrease from the December 31, 2009 level. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

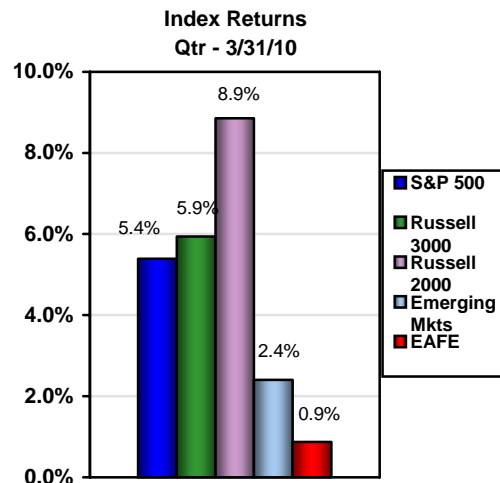
During the quarter, the Board conducted an asset-liability study resulting in a minor shift within the fixed income sector. Allocations to the other asset classes were unchanged. The Board also approved the 2010 commitment paces for both private equity and private real assets at slightly higher levels than 2009. The annual audit of the ERS was completed by the Board's external auditors, Clifton Gunderson, who issued a clean opinion with no management letter recommendations.

Capital Markets and Economic Conditions

Real GDP rose 3.2% during the first quarter with positive contributions from private inventory investment, exports, and personal consumption expenditures. Durable goods purchases were up strongly for the first quarter, but net exports grew at much slower rate than the previous two quarters. The U.S. manufacturing sector, as measured by the Institute of Supply Management's (ISM) composite, expanded for the eighth consecutive month in March. These statistics are indicative of economic growth and the potential for business expansion and higher employment in the future. However, despite these positive

signs of growth, it remains uncertain whether this growth is sustainable. Positive readings on GDP and manufacturing during the first quarter conflict with near-zero growth in personal incomes during the quarter. Disposable incomes actually fell reflecting that consumer spending is being financed from savings. Consumption expenditures cannot continue to outpace incomes indefinitely; employment and wage growth must expand to fill the gap. Despite these cautious economic readings, capital markets continued to strengthen during the first quarter, with equity markets rallying and bond credit spreads narrowing.

Public Equity Markets: The U.S. equity markets rose in the first quarter on improving corporate earnings, inventory restocking and rising business and consumer confidence. As shown in the chart to

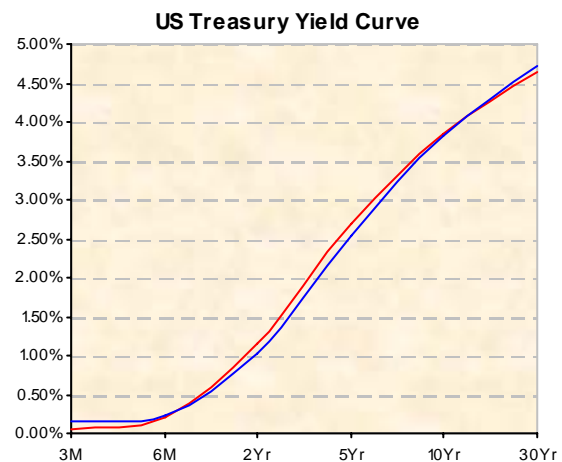


the left, smaller capitalization companies (Russell 2000 Index) outperformed their larger counterparts (S&P 500 Index). Both growth and value styles performed well during the quarter with value outpacing growth. The CBOE Volatility Index (VIX), a measure of anticipated stock market volatility, moved below 20 for the first time since August of 2008. In comparison, during the height of the credit crisis and market turmoil of 2008, the VIX traded as high as 80. All sectors of the S&P 500, except Telecom and Utilities, posted positive returns with Consumer Discretionary, Financials and Industrials all posting double digit returns. Our combined domestic equity performance was a gain of 6.16%, outperforming the 5.94% return recorded by the Russell 3000 benchmark.

Within the international equity sector, developed markets, as measured by the MSCI EAFE Index, were up 4.29% on a local currency basis, but a weakening Euro and British pound

resulted in just a 0.87% return in US Dollar terms. European equities were impacted by sovereign debt worries, particularly Greece, while Asia was buoyed by a rally in Japan, up 8.18%. Emerging markets advanced 2.40% in US Dollar terms. China and Taiwan experienced selling pressures over concerns that stock prices had exceeded near-term valuations. Our combined international equity performance was a gain of 4.04% for the quarter, 246 basis points ahead of the benchmark's 1.58% gain.

Fixed Income: At quarter end, Treasury yields had risen slightly on the long-end of the curve while shorter term rates declined. However, yields were volatile throughout the quarter on concerns over Greece's financial situation and US Treasury auction demand. The Federal Reserve voted to maintain its target rate at a 0% - .25% range and reiterated its view that current economic conditions warrant exceptionally low levels for an extended period. The yield curve (shown in the chart to the right) continued to steepen as the 2 year Treasury bond fell 12 bps from 1.14% to 1.02% and the 10 year Treasury bond remained at a 3.83%. Corporate bonds outperformed similar duration Treasuries as investor appetite for yield pushed credit spreads lower. The high yield bond market, represented by the Merrill Lynch High Yield Master II Index, gained 4.75%. Long investment grade credit issues also posted a gain, as reflected by the Barclays Long Govt/Credit Index return of 1.55%. Our combined fixed income performance for the quarter was a gain of 3.29%, outperforming the 2.30% gain recorded by the benchmark index. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, returned 2.44% for the quarter, compared to the 1.43% return of the benchmark.



Private Equity: Private equity transaction activity increased 10% over last quarter, registering both an increase in number of deals and a slight uptick in deal size. Some of this activity is being driven by the re-opening of debt markets that has occurred the last three quarters. Exit opportunities continued to be

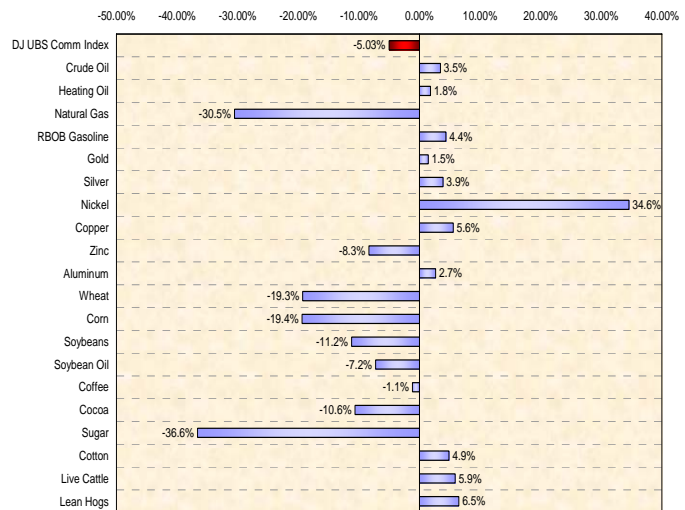
QUARTERLY REPORT

relatively strong, with more corporate acquisitions and deals between private equity firms. In fundraising, although more funds were raised during the first quarter, less total capital was raised. During the quarter, our private equity managers called a combined \$4.6 million and paid distributions of \$2.5 million. Our current allocation to private equity is 6.2%, with a market value of \$157.1 million.

Private Real Assets: Real estate investment activity globally was up significantly year-over-year and pricing trends were generally positive. In the U.S., increased availability of debt capital and low interest rates have contributed to more robust markets, particularly for high quality, well-located assets. However, many properties purchased during the 2006-2008 time frames continue to suffer from deteriorating fundamentals, which lag the performance of the economy due to the long-term nature of leasing contracts. In energy investing, improved technologies for recovering natural gas are increasing supply estimates, thus driving prices downward. These low natural gas prices are causing some firms to increase their focus on oil-rich assets in the near-term, which has boosted market activity for these properties. During the quarter, our managers called a total of \$1.5 million and paid distributions of \$0.3 million. Our current allocation to private real assets is 2.6%, with a market value of \$64.4 million.

Commodities: The DJ UBS Commodity Index declined 5.03% for the quarter. With the exception of metals and livestock, all major sectors were down. Grains (-16%) were the worst performing sector amid large inventories, sizable crops and sluggish demand. Within the energy sector, natural gas declined 30.5% as production continued and inventories levels rose despite falling prices. Base metals recorded a 6.1% gain driven predominately by demand from Asia in spite of high inventories and excess production capacity. On an individual commodity level, sugar fell sharply, down 36.6%; selling off after reaching 28 year highs in 2009. Nickel was the best performer, up 34.6% on expectations of rising demand from stainless steel mills. During the quarter, our commodities portfolio declined 3.44%, outperforming the return of the DJ UBS Commodities Index by 159 basis points.

Quarterly Commodity Performance



Additions

The primary sources of additions for the ERS include contributions from members and employers, investment income and the transfer of RSP account balances to the GRIP. The following table displays the source and amount of additions for the quarter ending March 31, 2010 and fiscal year-to-date.

Employees' Retirement System

Contributions and Investment Income (millions)

	Qtr 3/31/2010	Fiscal YTD
Employer Contributions	\$ 28.1	\$ 86.0
Member Contributions	4.9	15.5
GRIP Transfers	-	30.5
Net Investment Income	74.1	396.8
	<u>\$ 107.1</u>	<u>\$ 528.8</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

**Employees' Retirement System
Deductions by Type (millions)**

	Qtr 3/31/2010	Fiscal YTD
Benefits	\$ 42.1	\$ 125.0
Refunds	0.5	0.8
Administrative Expenses	0.7	2.3
	\$ 43.4	\$ 128.1

Outlook

Capital markets rallied during the first quarter, as most economic and sentiment news continued to show improvement. Pockets of uncertainty still exist, and investors will continue to weigh these risks relative to the global economy's strength as a whole. The major story for the first quarter was the Greek fiscal deficits and their impact on Greece's ability to issue euro-denominated debt at affordable interest rates. Discussions continue between the European Union, the International Monetary Fund (IMF) and Greece to resolve this issue. Investors will also follow developments in other European Union countries that have high debt levels relative to GDP, including Spain and Portugal. The resolution of the Greek debt situation will be an important hurdle for the international economy to overcome during the second quarter of 2010.

Outside of the developed international markets, the emerging market economies continue to boom. China has had several quarters of strong growth, igniting fears that their economy may overheat and cause inflation. Additionally the United States continues to put pressure on the Chinese government to revalue its currency, which is perceived to be undervalued. During the first quarter of 2010, and subsequent to quarter end, China has moved to tighten bank lending as a way to slow borrowing and therefore economic growth. Monetary tightening steps taken in China and other emerging market countries will be closely watched in the coming quarters as these economies have been the marginal drivers of growth over the past 12 months.

Through the first quarter of 2010, the S&P 500 stock index rallied 49.8% for the trailing one year period. Along with this rally, the housing market has stabilized in most metropolitan areas and borrowing costs have decreased substantially. These factors produce a wealth effect that makes investors and consumers more confident about the future, and reduces the incentive for households to save for future. With the continued improvement in sentiment, the labor market should begin to improve and the unemployment rate should begin to fall from its current level of 9.7%. If employers continue to be slow in their hiring pace, the strong economic recovery anticipated by the equity markets may not be realized. Indeed, many market experts, including the Federal Reserve Board, expect to see a period of slower than average recovery over the next several quarters.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**
March 31, 2010

Assets

Equity in pooled cash and investments	\$ 435,340
Investments:	
Northern Trust	2,526,130,624
Aetna	13,844,374
Fidelity - Elected Officials Plan	900,847
Fidelity - DRSP	3,398,683
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Total investments	2,544,274,528
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Contributions receivable	6,694,638
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Total assets	2,551,404,506
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Liabilities

Benefits payable and other liabilities	4,683,523
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Net assets held in trust for pension benefits	\$ 2,546,720,983
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**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**

March 31, 2010

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 28,067,045	\$ 86,000,692
GRIP Transfers		\$ 30,500,217
Member	4,885,083	15,528,879
Total contributions	32,952,128	132,029,788
Investment income	78,064,821	407,117,923
Less investment expenses	3,903,133	10,344,495
Net investment income	74,161,688	396,773,428
Total additions	107,113,816	528,803,216
Deductions		
Retiree benefits	30,394,548	90,477,217
Disability benefits	9,832,089	28,813,700
Survivor benefits	1,885,134	5,663,156
Refunds	540,918	849,070
Administrative expenses	709,509	2,278,285
Total deductions	43,362,198	128,081,428
Net increase (decrease)	63,751,618	400,721,788
Net asset held in trust for pension benefits		
Beginning of period	2,482,969,365	2,145,999,195
End of period	\$ 2,546,720,983	\$ 2,546,720,983